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Taxation of the extractive industries

"Trade mis-invoicing" and its relationship to "transfer mis-pricing"

Note by the Secretariat

Background

1. The Subcommittee on Extractive Industries Taxation Issues for Developing Countries of the Committee of Experts on International Cooperation in Tax Matters has requested the Secretariat to prepare a short note on the meaning of the term "trade mis-invoicing" compared with the term "transfer mis-pricing". The purpose was to determine the extent to which guidance on the former could be useful in the context of international tax cooperation, other than in the form of guidance on transfer mis-pricing, which had already been addressed in the *United Nations Practical Manual on Transfer Pricing for Developing Countries*.[1]

2. The request was made in the context of the report of the Subcommittee on its activities in 2015, in which the Subcommittee included, as part of its workplan (which was accepted by the Committee), work on the effective review of invoicing and costs (E/C.18/2015/CRP.2).

3. The term "trade mis-invoicing" has not been used in a uniform manner. Sometimes, it seems to be used as a synonym for transfer mis-pricing (or as at least dealing with underinvoicing — or logically, overinvoicing) that is matched between the exporter and the importer and would include many transfer pricing cases.[2]

* E/C.18/2016/1.

[1] United Nations, *United Nations Practical Manual on Transfer Pricing for Developing Countries* (New York, 2013).

[2] See, for example, Chamber of Mines of South Africa, "Trade Mis-Invoicing — Chamber Response to UNCTAD-Sponsored Report" (25 July 2016), available from http://www.chamberofmines.org.za/component/jdownloads/send/24-2016/259-trade-mis-invoicing-chamber-response-to-unctad-sponsored-report. The report of the United Nations Conference on Trade and Development (UNCTAD) being responded to ("Trade Misinvoicing in Primary Commodities in Developing Countries: The cases of Chile, Côte d'Ivoire, Nigeria, South Africa and Zambia" (2016), available from http://unctad.org/en/PublicationsLibrary/suc2016d2.pdf) certainly seems to be addressing related party dealings within transnational corporations.

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However, sometimes, it has been used to identify a practice distinct from transfer pricing.[3] In particular, as seen in paragraph 11 below, it is often used to address cases in which there are mismatched invoices between the exporter and the importer that show up in customs data. One highly relevant use of the term (and related terms) is that found in the report of the Economic Commission for Africa entitled "Illicit Financial Flows: Report of the High-level Panel on Illicit Financial Flows from Africa":

- **Trade mis-invoicing**. The act of misrepresenting the price or quantity of imports or exports in order to hide or accumulate money in other jurisdictions. The motive could, for example, be to evade taxes, avoid customs duties, transfer a kickback or launder money.
- **Abusive transfer pricing**. A transfer price may be manipulated to shift profits from one jurisdiction to another, usually from a higher-tax to a lower-tax jurisdiction. This is a well-known source of illicit financial flows, although not all forms of transfer pricing abuse that result in illicit financial flows rely on manipulating the price of the transaction.
- **Trade-based money-laundering**. A technique where trade mis-pricing is used to hide or disguise income generated from illegal activity.

4. Global Financial Integrity, an organization that has done a great deal of work in this area, has defined trade mis-invoicing as follows:[4]

> Trade mis-invoicing is a method for moving money illicitly across borders which involves deliberately misreporting the value of a commercial transaction on an invoice submitted to customs. A form of trade-based money laundering, trade mis-invoicing is the largest component of illicit financial outflows measured by Global Financial Integrity.

5. Global Financial Integrity provides a hypothetical example of trade mis-invoicing (with fictional country names), as follows:

> In this case of import overinvoicing, the [Taresian] importer illegally moves $500,000 out of [Taresia]. Although he is only buying $1 million worth of used cars from the [Caldarean] exporter, he uses a [Minsharan] intermediary to re-invoice the amount up to $1,500,000. The [Caldarean] exporter gets paid $1 million. The $500,000 that is left over is then diverted to an offshore bank account owned by the Taresian importer.

6. In such an example, there may not be transfer mis-pricing, given that the Taresian importer may not "formally" be a "related entity". It therefore appears that identifying the mis-invoicing that the two are involved in may be an important matter not covered by transfer pricing and the information available may be different. In a non-related party case, information such as a country-by-country report may not be of assistance.

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[3] Economic Commission for Africa, "Illicit Financial Flows: Report of the High- level Panel on Illicit Financial Flows from Africa" (2010):
"**Illicit financial flows (IFFs)**. Money that is illegally earned, transferred or utilized. These funds typically originate from three sources: commercial tax evasion, trade mis-invoicing and abusive transfer pricing; criminal activities, including the drug trade, human trafficking, illegal arms dealing and smuggling of contraband; and bribery and theft by corrupt government officials."

[4] See Global Financial Integrity, "Trade Misinvoicing", available from http://www.gfintegrity.org/issue/trade-misinvoicing/.

7. It is worth noting that in a classic transfer mis-pricing case, the two related parties would have the same incorrect price on both invoices and the transaction would not show up in the data that Global Financial Integrity, for example, uses to establish mis-invoicing, since that looks for different invoice values on the import and export sides. This is another reason why the term is often, although not always, used distinctly, i.e. not in reference to transfer pricing issues. The report of the High-level Panel clearly refers to intra-group transactions subject to transfer pricing analysis when it notes:

> Another widespread means to effect illicit financial flows from Africa is the misinvoicing of services and intangibles such as intra-group loans and intellectual property and management fees. Such practices are making an increasing contribution to illicit financial flows. This is partly due to the increasing share of services in global trade. Other contributing factors are changing technology and a lack of comparative price information. The growth in information and communications technologies has made it possible to transfer huge sums of money at the click of a mouse while also enabling innovative forms of mis-invoicing. It is easier to use the arm's-length principle to determine the proper price of merchandise than it is for intellectual property such as use of a brand name. It is similarly quite difficult to limit the advisory services that related companies can render to one another or to determine the maximum amount that they can lend one another.

8. The report of the High-level Panel refers to the related concept of trade mis-pricing, as follows:

> Trade mis-pricing is the falsification of the price, quality and quantity values of traded goods for a variety of purposes. These could range from the desire to evade customs duties and domestic levies to the intent to export foreign exchange abroad. The over-invoicing of imports has been practised by a variety of importers for a number of years, which is why several African countries have introduced pre-shipment inspection to detect such practices. We established that under-invoicing of exports was quite common in Africa, and particularly in the natural resource sector. The intention of such practices is to reduce the amount of money to be remitted to the exporting country from such sales.
>
> [...] Similar concerns caused Liberia to introduce the tagging of timber exports. This measure was found to be quite effective, as a result of which the Panel brokered contact between Liberia and the Democratic Republic of Congo, which was facing challenges in the same area.

9. This appears to be a very broad term of relevance to both transfer pricing and non-transfer pricing cases. The same report ultimately treats trade mis-pricing as a distinct issue from transfer pricing and recommends the following:

> African countries should ensure that they have clear and concise laws and regulations that make it illegal to intentionally incorrectly or inaccurately state the price, quantity, quality or other aspect of trade in goods and services in order to move capital or profits to another jurisdiction or to manipulate, evade or avoid any form of taxation, including customs and excise duties. The first step in revenue collection is to ensure that all corporations, big and small, are registered for tax purposes. In addition to existing registration requirements, countries may consider a provision in the respective acts regulating the registration of

companies or small businesses to the effect that no registration shall take place without proof of tax registration. In some countries, one cannot open a business bank account without proof of registration for tax. To avoid unnecessary delays in the registration of companies, the relevant agencies must have adequate capacity to process such registrations. We recommend further that the databases of the companies' registration office and the tax authority be linked. African States' customs authorities should use available databases of information about comparable pricing of world trade in goods to analyse imports and exports and identify transactions that require additional scrutiny. States should also begin collecting trade transaction data and creating databases from that information, which can then be searched and shared with other States so that a more robust dataset of local and regional comparables is available.

10. Global Financial Integrity has defined trade mis-pricing broadly (and as an invoicing issue) but with a less clear reference to quality and quantity issues, for example, as follows:[5]

> **Trade mis-pricing**: refers to the deliberate overinvoicing of imports or underinvoicing of exports, usually for the purpose of tax evasion. This practice is a significant component of illicit financial outflows and a major conduit through which residents of developing countries transfer money abroad illegally.

11. Global Financial Integrity has indicated to the Financing for Development Coordinating Secretariat that it has also run into the same confusion over the various terms used. It treats trade mis-invoicing (which, in its view, can also be referred to as trade fraud) as constituted by an illegal activity. Given that the data used by Global Financial Integrity for estimating trade do not allow for examination of individual transactions, that data cannot determine whether the parties to a transaction are related or not and therefore cannot determine whether the mis-invoicing is abusive transfer pricing. Nevertheless, as noted above, related parties are unlikely to have the mismatched invoices on the import and export sides that are often implied in the term "trade mis-invoicing". Global Financial Integrity has indicated that it does not use the term "transfer mis-pricing" given that it treats transfer pricing as either "transfer pricing" (a legal activity) or "abusive transfer pricing", which is an illegal activity, but must be determined to be abusive by a court).

12. The United Nations Practical Manual recognizes transfer pricing as a normal incident of international business, namely, having to price transactions between related entities. Transfer mis-pricing, on the other hand, is explained as follows:

> For the purposes of this Manual, the term "mis-pricing" is used to refer in a short form to pricing that is not in accordance with the arm's length standard. It is not intended to imply that a tax avoidance or evasion motive necessarily exists in a particular case. From the country development perspective, the impact of non-arm's length pricing does not depend on whether or not such an intention exists, though that may of course affect how countries respond to particular instances of such behaviour.

[5] Global Financial Integrity, "The Implied Tax Revenue Loss from Trade Mispricing" (2010), available from http://www.gfintegrity.org/report/the-implied-tax-revenue-loss-from-trade-mispricing/.

13. Transfer mis-pricing is therefore, in United Nations parlance, a pricing that does not reflect the arm's length standard for whatever reason. The term is clearly chosen to make clear that not all transfer pricing is problematic; however, it also expresses that an objectively non-arm's length price can give rise to adjustments under domestic law and bilateral treaties following article 9 of the United Nations Model Double Taxation Convention between Developed and Developing Countries and of the Organization for Economic Cooperation and Development Model Tax Convention on Income and on Capital without the need for an abusive intent or negligence as to abuse. This may be especially important for countries where the tax administration has a higher burden of proof.

Summary and conclusions

14. For the purposes of the work of the Subcommittee, the key conclusions are:

(a) There is no absolute clarity on the term "mis-invoicing" — with some parties appearing to include matching "mis-invoicing" (including between related parties) while others refer to mismatched invoices, which show up more readily in the customs data used. It is therefore sensible to avoid the term or at least to clarify how it is interpreted if used;

(b) On the mismatching invoices approach, calculations as to the extent of "trade mis-invoicing" would, in principle, include related party as well as unrelated party transactions, but should, in practice, not cover transfer mis-pricing to any great extent, since that would include matching invoices on both sides of the transaction — export and import;

(c) This mis-invoicing through mismatched invoices could occur in the extractive sector between unrelated parties, but there seems to be no reason to believe that it has any special application in that area. That is not to deny that if it does occur in that area, the impact on developing countries that are very dependent on commodities might not be disproportionately affected, although this is more likely to be in relation to exports than imports;

(d) Any impact would most likely be on customs duties rather than on taxes although, depending on the prevalent taxes and incentives, there could be some avoidance or evasion;

(e) Issues covered under the broad heading of "trade mis-pricing" appear to potentially cover invoicing issues, including as to quality and quantity, not just price, that may relate to both transfer pricing and non-transfer pricing cases; practical guidance in that area — ensuring that the invoicing reflects the correct actual quality grade and quantity, for example — could assist in both cases, but would be a significant undertaking.

15. Issues of transfer mis-pricing are addressed by a separate subcommittee, the Subcommittee on Article 9 (Associated Enterprises): Transfer Pricing, and while there will be interaction between the extractive and transfer subcommittees, as agreed in 2015, this work may have to be commenced in earnest in 2017, rather than 2016. Nevertheless, there does seem to be some room for suitable guidance on invoicing, not directly relating to transfer mis-pricing, which could be relevant to taxation of the extractive industries.

16. One non-transfer pricing area addressed by the report of the Economic Commission for Africa is cases where mis-invoicing is used to increase tax incentives for exports by overpricing the exports. That might be an issue if extractive commodities were subject to such export incentives on an ad valorem basis, which may not be very common.

17. Another possible area would be underinvoicing of imports. This could occur among related parties as part of a transfer mis-pricing arrangement, but also in relation to a transaction with an unrelated party. To the extent that these relate purely to customs duties, they are, however, probably outside the direct scope of the Subcommittee's mandate. There might be taxes that are imposed on imports (there are various taxes on imports into Brazil, for example).[6] The issue for the Subcommittee will be whether this is a sufficiently important issue for United Nations guidance in relation to the extractive industry.

18. The money-laundering motivation for some mis-invoicing may not be a major motivation in the extractive sector and, similarly, in relation to avoidance of capital controls. Given that they are not directly tax-related, in any case, they are perhaps not a suitable subject for the consideration of the Subcommittee.

19. If there is an issue other than transfer mis-pricing that is of relevance to the extractive industries, then guidance on how to detect such mis-invoicing and address it, possibly including legislative recommendations, could be useful.

20. The basic issues, noted in the excerpt on determining what amount or quality of a commodity is being exported, taken from the report of the High-level Panel (see para. 9 above), show that there may be room for general guidance about how to test the accuracy of invoicing as to quality, quantity, price and other aspects, of traded commodities especially, which would be of benefit in both transfer pricing and non-transfer pricing cases. This could be done without reopening specific transfer pricing issues about the pricing of related party commodity transactions that are already under consideration in the United Nations transfer pricing work and elsewhere.

21. In this context, the discussions on practical issues such as the quantification of actual exports in the report of the High-level Panel, as well as the discussion of practical steps to counter "trade mis-pricing" in that report (see para. 9 above) may point to possible areas for useful Committee guidance and Subcommittee work. It could probably not be completed by mid-2017, however, when the members of the Committee end their terms.

[6] See http://thebrazilbusiness.com/article/how-to-calculate-brazilian-import-duties-and-taxes.